Exploring the Reasons behind India's Chit Crisis

A Case Study on Corporate Governance Strategies of Saradha Group

A Synopsis

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Supervised by

Dr. Mini Amit Arrawatia

Submitted by

JV'n Vikram Pande

Department of Management & Commerce

Faculty of Management & Humanities

Jayoti Vidyapeeth Women's University

Jaipur, Rajasthan

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1 Introduction

"Chit funds" also known as chit or chitty involve financial transactions under which a foreman enters into a contract with a group of people (investors) who agree to deposit a certain amount of money in instalments for a fixed period of time with a promise to receive a prize amount in return as decided by the group or by auction or tender. Thus, it can be concluded from the above definition that chit fund is a financial scheme basically based on trust between the chit fund owner and the investor. The existence of the chit fund concept is from the time when even formal banking was not introduced.

Almost 193 registered chit funds operate in Bangalore which are registered under the Chit Funds Act 1982. These chit funds hold a turnover of approximately Rs. 4,000 crore per annum. On the other hand, the projected number of unregistered chit funds is 100 times than the registered ones. If the value of an unregistered chit fund is more than Rs. 100 it is considered to be illegitimate in India. There are many rules and regulations while investing in a registered chit fund. Moreover these rules are stricter when compared to the regulations of banking. This is the reason for the demotivation of investors to invest in registered chit funds and they get involved in the activity of investing in unregistered chit funds. Therefore, modification (simplification) in the policies and regulations would motivate people to invest in registered chit funds.

An Italian immigrant, Carlo "Charles" Ponzi, in 1920, formed the Securities Exchange Company. Ponzi introduced a choice of investments for the investors. The choice was between a fifty per cent return on a forty-five day investment and a hundred per cent return on a ninety day investment. Ponzi claimed that he had a special kind of understanding of the

international postal reply coupon system which made this kind of return on investment possible.

Sudipta Sen owner of the Saradha Group, an unregistered chit fund, started to practice chit fund by acquiring money from the public of West Bengal and other Eastern and Northern Eastern states. The Saradha group itself and the entities of the group were not registered as chit funds. With a motive to start a Ponzi scheme, the group apparently used the name of a group of companies with the help of some cross connections. To make the Ponzi scheme look like a genuine business, the scheme was advertised and made public by the group. To evade any kind of checks and examinations from the legal authorities side, the group used to make regular amendments in it's operational strategies.

On April 16, 2013, the first complaint was received by the Government of West Bengal against the working of Saradha Group. Within three days of complain the police came into action. In the first week of May, 2013, the Kolkata High Court ordered the government of Kolkata to file an affidavit for investigation by CBI of the chit fund scam involving crores of rupees. All the fourteen entities of Saradha Group including Saradha Reality India, Saradha Agro Development, Saradha Construction Co., Saradha Exports, and Saradha Garden Resorts and Hotels, etc. were under the process of investigation.

A report from the newspaper The Telegraph (a newspaper published in Kolkata) on August 19, 2013, stated that a total of 17.39 lakh applicants made complains about the scam out of which 83% of the applicants (approx. 14.43 lakhs) had deposited an amount equal to or less than Rs. 10,000. As per estimation, if the average deposit was Rs. 5,000 then the State Government would require at least Rs. 720 crore and in case of Rs. 7000 as average deposit, the pay amount would rise to Rs. 1,010 crore. Therefore the value of the scam was approximately Rs. 3000 crore.

In India, the chit funds are the indigenous financial organizations that combine the savings and credit in single scheme. In the study carried out by Kapoo et al Eds. (2014), they pointed out the fact that however the chit funds are a significant basis of finance for the low – income households and small businesses in India, there is a general evacuation of the low value chits from that the registered market of chit funds. However, there is also a chit fund crisis that arises, which use to create great loss to all the people who put money on that. So this study indents to explore the reasons behind the chit crisis in India through specifically analysing the case study on the strategies of corporate governance in Saradha Group

1.1 Aim of the study

The aim of the study is to analyze the reasons behind the crisis in chit funds in India which special reference to the Saradha Group

1.2 Objectives of the study

The following are the main objectives of the study

- To investigate the chit fund crisis in India and the reasons behind it and to analyze the corporate governance strategies in Saradha Group, West Bengal.
- To analyse the emergence of chit funds in India and their impact on the belief of investors
- To investigate the reasons that led to chit fund scam at Saradha Group
- To analyze the impact of scam on the Indian economy and the investors who invested in Saradha group.
- To analyze the reaction of the State Government about the scam and the steps taken by the Government of West Bengal to provide relief to the chit fund victims

1.3 Research questions

The following are the research questions of the study.

- How have chit funds emerged in India and how have they impacted the belief of investors in the recent times?
- What were the factors that resulted in chit fund scam by Saradha group?
- What is the impact of scam on the Indian economy as well as the investors who invested in Saradha group?

- What was the reaction of the State Government towards the scam and the steps taken by the Government of West Bengal to provide relief to the chit fund victims?

2 Review of Literature

2.1 Introduction

This chapter will give a review of the history of chit funds. The way the idea of chit funds was misused by many people is the main issue of this chapter. Many unregistered chit fund firms operated in India due to soft penal regulations against them. The concept of chit fund was a big support for the poor and lower income class to save and borrow money but the operators of the chit fund firms took disadvantage of the trust of the investors and made the investors bankrupt for their benefit. This chapter focuses on the Saradha Group chit fund scandal. This chapter also details the involvement of the government in the recovery of the economy from the scam.

2.2 History of Chit Funds

The concept of chit funds has been in practise since 1000 years ago. The chit fund system was initially the grain chit or Dhanya Chittu. Initially under the concept of chit fund, in a village a group of people contributed types of grain and deposited it to a foreman of their choice. The entire collection was given to the selected foreman, this was known as Kudavolai. For selecting the foreman, the names of the members were written on palm leaves (olais) and were collected in an earthen pot (kudam). A leaf was picked from the pot and the name in it became the foreman. The main purpose of the traders to practise chitties was borrowing. The prize amount collected by the investors was further invested by them for expansion of their business. The chit funds are different from other financial tools as they create a link between the borrowing class and the lending class and the collected money is lent to the same group of savers.

2.3 Emergence of fraud Chit Funds

Chit funds also popularly known as “cheat funds” are doubtful bucket-shops. West Bengal had been the target of this concept from the late 1970s and 1980s by many companies. Sanchayita, Sanchayani, Favourite, Overland, etc. are names of some companies which were introduced in West Bengal. All these companies were simply Ponzi schemes which closed down resulting to ruining the financial conditions of the investors (in these company) leaving them bankrupt.

In 1990s, the state again experienced the emergence and growth of such chit fund companies but this time it was different, such chit funds were getting the support of the Left Front politicians. Unsecured debentures with 20-30 % interest rates were issued to the consumers. The agents were getting a commission of 30-35%. Advertisements and notices were generated for such issues but the government did not took any strict actions against such fraudulent practises which resulted in the success of these chit funds in West Bengal, Kerala, and Tripura.

2.3.1 Reasons for emergence of unregistered/fraud chit funds

In a survey made by the Institute for Financial Management and Research (IFMR), it was found that 96 % of the total chit fund participants believed that chit fund operations were safe. It brought forward the importance of chit funds. Chit funds acted as a tool of saving and borrowing for the poor and low income people in India. The report from the survey also stated that around 10-50% of capital was borrowed from the registered chit funds. It was also stated that although chit funds played a vital role in providing finance to small businesses and low-income people, still the registered chit fund market avoided the use of low value chit fund schemes. They did so, because the cost of operating was high for such schemes. Thus, the market was not interested in serving the poor which made the poor loose the opportunity of saving and borrowing.

The reasons for the strengthening of the market position of Saradha group, an unregistered chit fund were many. Some of them are: - a) A state where the employment rate is only 11%, the population got attracted towards the Ponzi scheme as it provided easy and quick money. b) Moreover the presence of the Chief Minister at the newspaper launches by Saradha and the support of the top leaders and activists for Saradha automatically created goodwill of Saradha among the common. c) Punishments and provisions for unregistered chit funds were too lenient.

After the Saradha Group scam the general secretary of All Indian Association of chit funds, T.S. Sivaramakrishnan blamed the provisions regarding functioning of an unregistered chit fund. He also specified that the Registrar of Chits never took steps against chit fund firms which were unregistered but still operating. This negligence of the Registrar towards the unregistered chit fund firms is a big cause of happening of so many chit fund scams within a short period of time. The general secretary also suggested some amendments that should be made in the penal provisions against the unregistered chit funds. Such as the time period for imprisonment should be increased and the penalty amount should be increased from Rs. 5,000 to Rs. 500,000.

After the investigation of the Saradha group, it was found that there were still many other fraud companies who were providing fraud chit fund schemes in the state of West Bengal. Like the Saradha group, there were many companies (along with their entities) who with their fraudulent practises became the target of the CBI and had to undergo investigation. These companies included the following names: Sunshine India Land Developers and it's nine entities, Icore E- services and it's eleven entities and Rose Valley group and it's nineteen entities.

2.4 Government's say on the Scam

When the whole economy of West Bengal was suffering from the various fraud chit fund scams and scandals, the Government of West Bengal at the initial stage had a doubt that it was a conspiracy to ruin the economy of West Bengal. So, the Government requested the public to be more cautious towards investments and chit funds. Understanding the need of the hour, the Government had to take measures to overcome such instability in the economy and control the chaos created among the public (especially the poor and the low income class). The State Government wanted the various Central Bodies also to provide financial help to the victims.

After the scam of Saradha group scam became public, the Chief Minister of West Bengal, Mamata Banerjee on April 24, 2013 announced that investors need to be more careful and alert while investing in chit funds. As the state had no such strict law or policy against fraudulent chit funds, CM wanted to introduce a strong bill. As a result of which a special session of assembly was conducted between 26 April and 6 May, 2013 with a motive to pass a bill in the state assembly with immediate effect. The bill would give the State Government the power to take over the assets and properties of the Saradha group, sell them in an auction and make payments to the scam victims. CM wanted the bill to pass as soon as possible so as to take strict legal actions against the fraud chit fund companies. These actions of the Trinamool Congress (TMC) showed their sense of responsibility towards it's public especially the poor and low income class people (who were the major victim of the scam).

The Chief Minister of West Bengal, Mamata Banerjee even ordered the police department of West Bengal to take quick actions against the personnel responsible for the scam. Soon the efforts of the police department showed the results and the owner of the Saradha group Sudipta Sen, who succeeded in escaping from the state was arrested from Sonamarg in Kashmir. An employee of the group named Arvind Singh Chauhan and a close associate of

Sen named Debjani Mukherjee were also caught by the police by the second week of May, 2013.

The government of West Bengal then announced to set up a relief fund of Rs. 500 crore to make payments to the low income depositors especially, in spite of some severe limitations of finance. This announcement of the State Government was a sign of relief for the victims of the scam. To raise funds for this relief fund, the State Government imposed tax on cigarettes and tobacco products at the rate of 10%. An amount of Rs. 150 crore out of Rs. 500 was to be raised from these taxes. The rest of the amount of the relief fund would be arranged by the government without giving any pressure to the common public.

This effort to make a relief fund could not succeed as there were no such policies for making funds in the budgetary rules. As the State Government was not able to make a relief fund due to the shortcomings in the budgetary rules, it proposed a new legislation under the Article 282 of the constitution which would allow a Union or a state to raise such funds or grants for the benefit of the common. The State Government discovered that the amount of Rs. 150 crore that was expected to be raised from taxes would not be enough for the fund. Therefore the Government decided to issue a fresh notification regarding allotment of the belongings and properties of the Saradha Group would be sold and the earnings from it would be used to raise funds and make payments to the poor victims of the scandal who have become totally bankrupt. On 2nd August, 2013, The Telegraph reported that almost 450 bighas of Saradha were found in Bengal and other states, along with almost 500 bank accounts and 100 vehicles and 220 other properties.

2.5 Serious Fraud Investigation Office

The Serious Fraud Investigation Office was established in the year 2003. The recommendations in the Naresh Chandra Committee Report on Corporate Audit and Governances led to the formation of SFIO, as an organisation of the Ministry of Corporate

Affairs. According to the committee there was a need of a multi-disciplinary team that could discover frauds as well as had the ability to control the prosecution with the help of various economic legislations. The staff of SFIO had experts from various fields like auditing, law, accountancy, tax, investigation, financial transactions, capital markets, investigation, IT. Some cases probed by SFIO included the Satyam scandal, Reebok India (which had a fraud of Rs. 870 crore), Sesa Goa (involving over and under invoicing of exports and imports worth almost Rs. 1,000 crore).

The powers of the SFIO were restricted only to the limit of inspecting the documents. It did not have the right to find, capture or arrest if needed. The SFIO operated in connection with some other authorities in such cases. The other authorities included the Crime Branch of India, the Central Economic Intelligence Bureau, the Reserve Bank of India, the Securities Exchange Board of India. These were also had the power to investigate. As the SFIO had some faults (some stated above) the Companies Bill 2012 (passed in the Parliament in December 2012) tried to make some amendments in SFIO to make it stronger. As result of which SFIO was a statutory body which could start prosecution as per the directions of the Central Government. Yet Saradha group succeeded in escaping from the eyes of SEBI. The group used to dump all its documents of inappropriate information to avoid any kind of investigation.

3 Research and Methodology

3.1 Introduction

Research methodology (RM) includes three basic sections, research methods, data collection methods and sampling, and interpretation (Stewart, D. W., & Kamins, M. A., 1993). RM for this study would follow the same process and performing of the first two sections one by one. Research methods are decided first and on that basis sampling and data collection is done. A

research could be conducted with any one of the three basic methods of research that is decided on the very purpose or objective of the study. The three types are exploratory, descriptive and causal researches that are applied with specific research requirement of the study. In this study, descriptive study would be carried out since the descriptive study helps in find out the exact situation and helps in make assessments on the reasons behind the scam of Saradha Group and its impact on the investors.

3.2 Research Methods

The research method is of three types: - exploratory research, causal research, and the descriptive research. The Exploratory research is done in cases where information is required in a broad context. Application of this type of method provides a better understanding of a situation. Exploratory research does not help in finding solutions to problems or making a final decision. It helps in developing a hypothesis related to the situation. Exploratory researches are applied in cases where something new has to be explored out and new concept, theories or principle etc. have to be developed. This type of research is mostly done with the help of extensive literature review, secondary data sources or focus group interviews (Stewart, D. W., & Kamins, M. A., 1993). Fundamentally, exploratory researches are done to find out the key variables that may be independent or dependent. Academic research is the best example of exploratory research however this research type has universal applicability to develop a sense of understanding about the areas still untouched.

Causal researches are done to establish a cause and effect relationship between the key variables. Impact of independent variables over the dependent, the variables is defined with causal researches. Descriptive researches are used to describe the characteristics of variables that are having impact over the phenomena. Descriptive research is underpinned to provide the description of observations of phenomena with a clear mapping of all the objects that are included in the study. Descriptive researches are done with the help of primary data generally

and involve extensive surveys, interviews etc. to collect data for completion of the study. In some cases where the research path is not so clear, hypotheses for the research is set out before the data collection and that is proved with statistical analysis of the responses obtained through primary sources. This study will follow the descriptive research method. In this study, quantitative research method will be used. It is since, basically the quantitative is descriptive in nature (Jackson, 2011).

Descriptive research involves three main categories: observation, case studies, and surveys. For conducting this research we will follow the survey methods which participants answer questions administered through questionnaires (close-ended). However as the primary data will be required to be collected via victims of the scam of Saradha group in the state of West Bengal there are chances that the response rate of questionnaires is low and not sufficient for analysing and processing. Further it will not possible for anyone to travel to every possible areas to collect data or read and speak every language therefore based on the response rate received from questionnaires, Schedule Method or help from Local Agents will be used.

In schedule method the questionnaires are sent through the enumerators to collect information. Enumerators are persons appointed by the investigator for the purpose. They directly meet the informants with the questionnaire. They explain the scope and objective of the enquiry to the informants and solicit their cooperation. The enumerators ask the questions to the informants and record their answers in the questionnaire and compile them. Also help from local agents or correspondents shall be taken. These agents will be appointed by the local agency contacted by the researcher. They are well conversant with the local conditions like language, communication, food habits, traditions etc. Being on the spot and well acquainted with the nature of the enquiry they are capable of furnishing reliable information.

3.3 Target population and sample

The target population of the quantitative study are the victims of the scam of Saradha group in the state of West Bengal. The sample size of the study will be 300.

3.4 Data Collection

Data can be collected with the two basic methods that are through primary and secondary data collection sources. Primary sources of information are needed to have knowledge of current conscience, thinking and views of respondents directly which paves the ways for obtaining solution on ground reality (Daas, P. & Beukenhorst, D., 2008). A structured questionnaire is prepared for recording the responses of respondents or help from local agents will be taken. Secondary data refers to the second hand information. Secondary data can be numeric and non-numeric. As the data in this case is already collected, therefore it is less accurate in comparison to the primary data. Secondary data can be collected from various sources which can be generally classified into two types i.e., published sources and unpublished sources (Patton, M.Q., 1990).

Non-numeric or qualitative secondary data include data collected from interviews, accounts, documents, conversations, photographs, government publications, journals, books and articles, etc. These serve as useful literatures for the research study to be conducted (Daas, P. & Beukenhorst, D., 2008). This study will use both primary and secondary data. The primary data will be collected from the victims of scam of Saradha Group in order to understand the impact of scam and how the steps taken by Government help them in this concern. The secondary data in this report is collected from journals, newspaper articles and publications. . The primary data will be collected through surveys with the use of closed – ended questionnaires. Based on the response rate, enumerators or help from local agent will be taken.

3.5 Limitations of the Research

It is a universally accepted fact that every research has limitations and it can never be 100 per cent accurate. The limitations can be external and internal. Internal limitations can be the data and material used, the extent to which a problem has been researched, and the final result derived from the data. It is not possible for anyone to travel to every possible library, museum to collect data or read and speak every language, this act as an external limitation in a research. Similarly the accuracy of the data collected by enumerators or agents depends on the honesty, skills and sincerity. However, research is done in a manner that it could give the best possible solution to the problem. Census studies or complete enumeration techniques become more relevant than sampling techniques for serving the purpose of generalization but it is difficult to conduct census in every case.

Use of primary data may become a big limitation when respondents either do not respond or respond with opaque, ambiguous or fake answers. This research follows the secondary data collection method where data collected from newspaper articles and journals do have limitations. This report has considered only one example of chit fund crisis in India i.e., the scandal of Saradha group. Moreover the report has only considered the secondary data and no information could be collected from the primary data. The data collected from secondary sources are not 100% accurate; therefore there are possibilities of misinformation.

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